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CENTRAL BANK OF MALTA
OUTLOOK FOR THE MALTESE ECONOMY

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OUTLOOK FOR THE MALTESE ECONOMY 2022-2025

Overview[1,2]

Despite the ongoing weakness in the international economic environment, latest national accounts data for Malta has surprised on the upside. This implies that the positive impact of reopening effects and the normalisation in travel on economic activity have been stronger than previously envisaged. Indeed, both private consumption and tourism exports have been more dynamic than previously expected, and hence projections for this year indicate a significant upward revision compared to the Bank's previous (August 2022) projections.

Nevertheless, the underlying headwinds from the international economic environment are likely to have a more marked impact in the final quarter of 2022, and beginning of 2023. In addition, despite some easing of global supply chain disruptions, inflationary pressures remain elevated and widespread, as higher costs are being passed on to import and consumer prices with a lag.

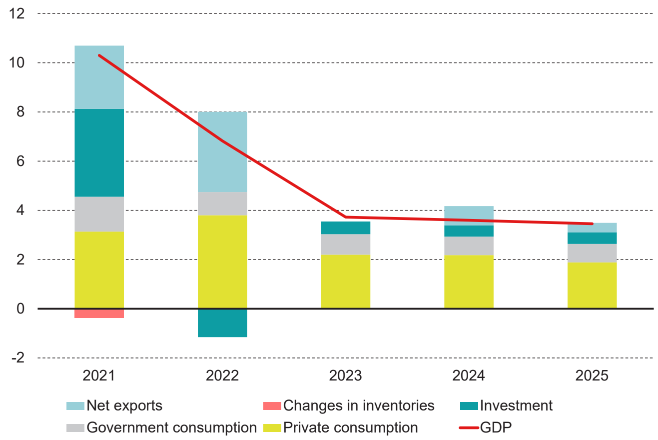
Given the more adverse international economic environment as well as higher inflation, economic growth next year is expected to be weaker than previously projected. Moreover, disruptions to supply and shortages of key vital inputs are expected to continue to have some impact also in 2023.

Price-mitigating fiscal measures continue to provide support as energy prices in Malta remain fixed. Hence, overall HICP inflation, while significantly higher than target, it remains below that in most euro area countries. Partly in view of this support, Malta is expected to avoid the recessionary pressures faced by some of its trading partners. Economic growth is expected to remain close to potential between 2023 and 2025.

Economic outlook

According to the Bank's latest forecasts, Malta's gross domestic product (GDP) is projected to grow by 6.8% in 2022 and by 3.7% in 2023, followed by 3.6% and 3.5% in 2024 and 2025, respectively. When compared to the previous projections, the Bank's latest forecast presents an upward revision of 1.6 percentage points for 2022, and downward revisions of 0.8 percentage point for 2023, and 0.1 percentage point for 2024 (see Table 1). The upward revision in 2022 reflects outcomes in the first half of the year which point to more dynamic economic activity than previously envisaged. The positive surprise was primarily driven

Chart 1
GDP GROWTH PROJECTIONS
(annual percentage change)



Source: Central Bank of Malta.

[1] The Bank's projections for the Maltese economy are based on information available up to 29 November 2022. The GDP release for the third quarter of 2022, published on 29 November, has not been taken into account due to the cut-off date.

[2] See https://www.centralbankmalta.org/site/Publications/Projections-2022-3.pdf.

Table 1
PROJECTIONS FOR THE MAIN MACROECONOMIC AGGREGATES FOR MALTA[1]

	2021[2]	2022	2023	2024	2025
Real economic activity (% change)					
GDP	10.3	6.8	3.7	3.6	3.5
Private consumption expenditure	7.1	8.9	4.9	4.8	4.1
Government consumption expenditure	6.7	4.6	4.2	3.8	3.8
Gross fixed capital formation	17.3	-5.4	3.4	-0.5	2.2
Exports of goods and services	9.0	6.9	2.5	3.2	3.1
Imports of goods and services	8.0	5.3	2.8	3.0	3.1
Contribution to real GDP growth (in percentage pts)					
Final domestic demand	7.7	3.6	3.7	2.8	3.1
Net exports	2.6	3.3	0.0	0.8	0.4
Changes in inventories	-0.4	0.0	0.0	0.0	0.0
Balance of payments (% of GDP)					
Goods and services balance	4.3	4.9	3.7	3.8	3.7
Current account balance	-4.6	-4.0	-4.2	-3.8	-3.9
Labour market (% change)[3]					
Total employment	2.9	4.9	2.9	2.3	2.2
Unemployment rate (% of labour supply)	3.5	3.0	3.0	3.2	3.3
Real disposable income[4]	5.2	2.5	2.0	3.5	3.4
Household saving ratio[4]	31.2	26.8	24.8	24.0	23.6
Prices and costs (% change)					
GDP Deflator	1.8	3.8	2.9	2.0	2.0
RPI	1.5	6.1	4.4	2.2	1.9
Overall HICP	0.7	6.1	4.5	2.3	2.0
HICP excluding energy	0.9	6.6	4.8	2.4	2.2
Compensation per employee	4.8	4.1	4.9	4.0	3.7
ULC	-2.2	2.3	4.1	2.7	2.4
Business Cycle					
Potential output (% change)	4.0	5.4	4.6	3.8	3.6
Output gap (% of GDP)	-0.2	1.2	0.3	0.1	0.0
Technical Assumptions					
EUR/USD exchange rate	1.20	1.00	1.00	1.00	1.00
Oil Price (USD per barrel)	71.1	104.7	85.7	78.7	74.8

Sources: NSO; Central Bank of Malta.

[1] Data on GDP were sourced from NSO *News Release* 154/2022 published on 25 August 2022, while RPI and HICP data were sourced, respectively, from NSO *News Releases* 213/2022 and 209/2022 (published on 22 November 2022 and 17 November 2022). HICP projections also include the flash estimate of November 2022.

[2] Actual data.

[3] Employment data are consistent with the national accounts. The unemployment rate is based on the number of unemployed and employed as reported in the Labour Force Survey.

[4] Central Bank of Malta estimates.

by stronger than expected growth in exports and private consumption. This faster recovery leads to a downward reassessment in GDP growth for 2023 and, to a much lesser extent in 2024. This is also driven by a deterioration in the international environment and the effects of high inflation.

In 2022, both domestic demand and net exports are expected to contribute significantly to GDP growth, owing to relatively strong exports and private consumption growth (see Chart 1). Going forward, domestic demand is expected to be the main driver of growth as investment begins to recover after this year's contraction, while consumption is expected to remain relatively robust. The net export contribution turns slightly negative in 2023, as tourism exports grow at a significantly slower rate following the stronger than expected rebound seen in 2022. The net export contribution is mildly positive in the outer years, as foreign demand more generally recovers.

Private consumption growth is expected to have accelerated from 7.1% in 2021 to 8.9% in 2022, which reflects the restart of high contact service activities on a broader scale and a better-than-expected recovery of tourism, especially during summer. Moreover, consumers continued to draw on their pandemic-related savings to sustain their consumption in a high-inflationary period. Thereafter, private consumption growth is projected to moderate, although it is nevertheless set to outpace the Bank's estimate of real disposable income growth. The saving ratio is thus envisaged to retreat over the projection horizon from recent peaks, to fall below 2019 levels in 2024.

Government consumption is set to rise by 4.6% in 2022, mainly due to higher outlays on compensation of employees and intermediate consumption. These two items are, however, set to grow at a slower rate than in 2021, which featured one-off expenditures on allowances and significant outlays on treatment and vaccination for COVID-19. In 2023, government consumption is set to grow by 4.2%. Growth in government consumption is then set to moderate to 3.8% in 2024 and 2025, as outlays on intermediate consumption are expected to grow at a slower pace.

Investment is projected to decline by 5.4% this year, reflecting a base effect in equipment investment due to extraordinary outlays in import-intensive transport equipment in the aviation sector during 2021. Investment is then forecast to grow by 3.4% in 2023, fall by 0.5% in 2024, and grow by 2.2% in 2025.

Private investment is expected to contract in 2022, reflecting a decline in equipment and non-residential construction, while residential construction is projected to grow at similar rate to that seen in 2021. Private investment is set to recover in 2023 and grow at rates of close to 3% per annum over the projection horizon.

Government investment is set to decline by 0.7% in 2022, before growing by 4.4% in 2023. However, it is set to decline strongly in 2024 (by 14.5%) and to decline by a further 1.1% in 2025. This profile is partly driven by the expected take up of EU funds, notably the full absorption of funds from the 2014-2020 financing framework by 2023, and the increased take up of RRF grants in 2023 and 2024. It also reflects a decline in domestically funded investment over this period.

In 2022, export growth is expected to remain robust in line with the solid performance of the tourism sectors and non-travel services exports. Growth in both goods and services exports has surprised on the upside, while non-travel services exports were broadly in line with the Bank's August projections. The former reflects higher than expected demand for electronic products while the latter is due to a stronger than assumed recovery in tourism exports.

Services exports are projected to grow by 7.1% in 2022. Non-tourism related services exports remained robust and resilient to the main channels of transmission of the Russia-Ukraine conflict. With regards to tourism exports, these have been revised up to 86% of 2019 levels in this forecast round, from the 75% of 2019 levels in the August round. The upward revision primarily reflects recent outturns. Services exports are then projected to grow at a significantly slower rate of 2.7%

in 2023, following the strong growth in 2022, although they are still set to outpace foreign demand. However, they are expected to grow in line with foreign demand in the following two years.

Despite expectations that goods exports might be more directly affected by the conflict, growth is expected to remain buoyant in 2022, at 6.0%, owing to recent outturns and reports from the Bank's contacts in industry of double-digit growth for the year. Thereafter, growth is expected to moderate significantly, in line with foreign demand.

With regards to imports, growth is expected to slow down compared to 2021, due to the aforementioned base effect from the extraordinary outlays on aviation investment, though remaining robust (5.3%). Import growth is set to moderate to rates of around 3% over the remainder of the forecast horizon.

The current account deficit is envisaged to decline to 4.0% this year from 4.6% in 2021, which reflects the widening of the trade balance. It is then set to increase to 4.2% next year due to the narrowing of the trade surplus and settle at 3.9% in the following two years. With regards to primary income, net outflows are expected to decline as a share of GDP due to lower profitability of foreign-owned firms (in view of the expected slowdown in activity). The secondary income account ratio is envisaged to remain stable.

Potential output

Potential output is expected to pick up, growing by 5.4% in 2022, up from 4.0% in 2021 (see Chart 2). This pick-up mostly reflects a higher contribution from labour following strong net migration flows projected for 2022. Moreover, the contribution of the capital stock is also expected to improve this year reflecting the extraordinarily high investment outlays in 2021. The contribution of total factor productivity is envisaged to fall marginally and stabilise thereafter to around its long-term average.

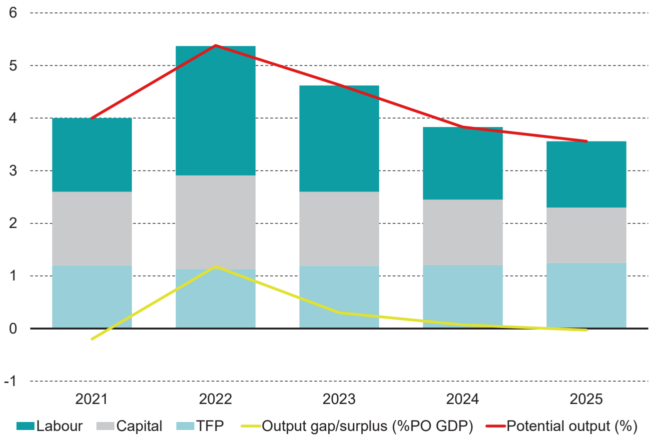
Potential output growth is set to moderate to 3.6% by 2025, reflecting lower contributions from labour and capital.

The economy is expected to be operating above potential this year, with the output gap standing at 1.2%. The output gap is expected to narrow somewhat to 0.3% and 0.1% in 2023 and 2024 respectively, and close in 2025, in view of the faster slowdown in GDP growth relative to potential output.

Labour market

The labour market is expected to remain tight over the projection horizon. Employment growth surprised on the upside in the first half of 2022 (5.2%

Chart 2
POTENTIAL OUTPUT
(annual percentage change; percentage of potential output)



Source: Central Bank of Malta.

compared to a projection of 3.5%), and this is reflected in a strong employment growth rate for the year as a whole (4.9%). Employment growth is set to slow down progressively over the rest of the projection horizon, reaching 2.2% by 2025, as GDP growth moderates. This year's pick-up reflects the continued strong demand for labour in the context of historically high labour shortages. That said, net migration flows appear to have picked up sharply already in the first half of 2022, and further increases in the second half of the year should alleviate to some extent the broad-based labour shortages.

The unemployment rate is forecast to stand at 3.0% in 2022 and 2023, 3.2% in 2024 and 3.3% in 2025. Despite the gradual increase in the unemployment rate, the negative unemployment gap is expected to persist, as the NAIRU is projected to be slightly higher. The latter is estimated to stand at 3.5% in 2025.

In view of the increase in inflation this year, as well as tight labour market conditions, wage growth is projected to be relatively strong. Nevertheless, nominal wage growth is projected to remain below consumer price inflation this year due to some lag in the transmission from prices to wages. In later years, it is expected to remain robust and outpace consumer price inflation. Compensation per employee is thus set to grow by 4.1% in 2022, 5.1% in 2023, 4.1% in 2024 and 3.9% in 2025.

Over the projection horizon the Bank expects labour market tightness to ease somewhat as net migration flows continue to increase. This easing of labour market tightness should to an extent mitigate the upward pressure on nominal wages by 2025.

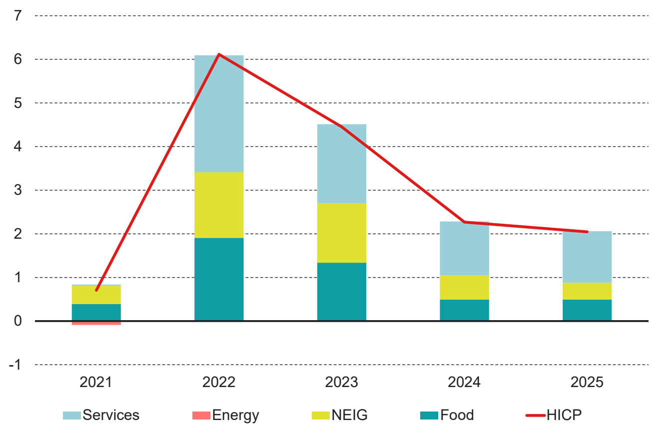
Prices

With regard to consumer prices, annual HICP inflation is projected to average 6.1% in 2022, up from 0.7% in 2021. The sharp pick-up in inflation reflects a broad-based increase across all subcomponents of HICP, except for energy inflation (see Box 2). Services is envisaged to be the main contributor to HICP inflation, but food and non-energy industrial goods (NEIG) are also projected to contribute strongly to annual HICP inflation this year (see Chart 3).

In 2022, the sharp pick-up in services inflation primarily reflects spill overs from other subcomponents, such as food and NEIG, as well as the impact of activity reopening effects. In addition, labour costs are envisaged to remain buoyant.

Food prices are projected to rise strongly in 2022, reaching an inflation rate of 9.1%, up from 1.9% in 2021. Indeed, both processed and unprocessed food inflation are expected to increase sharply. This reflects the indirect impact of higher import prices for most commodities and the rise in freight costs.

Chart 3
HICP INFLATION PROJECTIONS
(annual percentage change; percentage point contributions)



Source: Central Bank of Malta.

NEIG inflation is similarly expected to increase strongly due to higher import price pressures both for intermediate inputs and for final consumer goods due to higher imported product prices and freight costs.

Despite the increase in international energy commodity prices, energy prices are expected to remain unchanged during the whole projection horizon, in line with the Government's policy of keeping energy prices stable (see Box 1 for more details on the Bank's energy block in its inflation projections).

Import price pressures are expected to gradually ease by the beginning of next year, although these are envisaged to remain high by historical standards. HICP inflation is expected to moderate to 4.5% in 2023, driven by lower contributions from all subcomponents except for energy inflation, which will be equal to zero throughout the forecast horizon. Inflation is set to ease strongly in 2024 and 2025, to 2.3% and 2.0%, respectively.

When compared with the Bank's August forecast publication, overall HICP inflation has been revised up by 0.2 percentage point in 2022, 0.6 percentage point in 2023 and by 0.2 percentage point in 2024. The upward revision in 2022 partly reflect slightly stronger than projected inflation outcomes in recent months, as well as higher pressures from international commodity prices. Revisions in the following two years also reflect higher persistence in imported inflation as well as the envisaged pick-up in wages.

BOX 1: REVIEWING THE ENERGY BLOCK WITHIN THE NARROW INFLATION PROJECTION EXERCISE (NIPE)[1]

The Bank's inflation forecasting has been developed also to provide input to the Eurosystem's Narrow Inflation Projection Exercise (NIPE). The exercise is based on a highly disaggregated framework of the subcomponents of the Harmonised Index of Consumer Prices (HICP), which are projected on a monthly frequency. Given the short-term nature of the exercise, most components are projected using an auto-regressive integrated framework (ARIMA). Other components are projected using pricing rules.

In this framework, energy prices in Malta are modelled using pricing rules, which attempt to reflect the typical transmission of wholesale prices to consumer prices. Projections for wholesale prices are conditioned by forecasts for international energy prices and exchange rates, which are transmitted by the European Central Bank (ECB) to all euro area national central banks during a projection round.

The transmission mechanism of wholesale prices to consumer prices in Malta has changed considerably over the past few years. This reflects substantial changes to the energy mix, the overhaul in parts of the energy infrastructure, as well as more direct changes in the authorities' pricing behaviour.

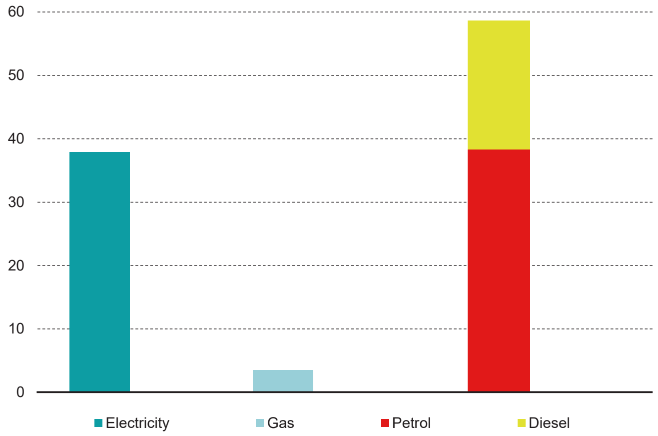
Within this context, the Bank has recently reviewed the energy block within the NIPE framework. This box outlines in more detail the process for projecting energy prices.

Subcomponents of energy index

Within HICP, energy prices can be further subdivided into three main subcomponents: electricity (CP0451), gas (CP0452), and fuels and lubricants for personal transport equipment (CP0722). In Malta, gas is only utilized for limited purposes and is distributed to households in LPG gas cylinders. With regards to fuels and lubricants, this is further subdivided into diesel and petrol.

According to the 2022 weights within the HICP index, energy prices in Malta have a weight of around 6.7% in total prices. Chart 1 shows that 37.9% of the energy

Chart 1
WEIGHTS IN ENERGY INDEX
(percentages)



Source: Eurostat.

[1] Prepared by Ian Borg, Manager within the Economic Projections and Conjunctural Analysis Office.

subcomponent within HICP is due to electricity, while 58.6% is due to fuel. In turn, petrol prices contribute to 38.3% of total energy prices, while the diesel weight stands at 20.3%. Gas is the smallest component, with a weight of 3.5%.

All energy prices in Malta are fully administered, according to Eurostat's definition.[2]

Electricity prices

Malta's electricity supply depends on four main sources: local generation (typically fuelled by gas oil and are utilized for emergency use), renewable sources (mainly solar energy), power plants operated by significant Independent Power Producers (IPPs), and an interconnector with Sicily. Power plants operated by IPPs are fuelled by natural gas and are covered by long-term bilateral agreements.

The electricity pricing model follows two steps. As a first step, wholesale prices for Malta's sole electricity distributor are projected. For the purpose of the projection exercise, we model and project wholesale prices related to the interconnector and IPPs power plants, which together account for around 93% of electricity supply in Malta. Total wholesale prices are thus equal to a weighted average of these two sources.

The long-term bilateral agreement to supply natural gas that fuel IPPs power plants is essentially linked to developments in brent crude oil prices and the euro-dollar exchange rate. Projections are hence conditioned on the ECB's transmission of projections for these two components. In cases where reliable information about hedging agreements is available, the pricing rule above is replaced by the hedged price for the hedging period.

With regards to the interconnector, Malta typically pays the hourly spot price charged on the grid. Interconnector prices are projected using an error-correction mechanism (ECM), in which prices are a function of Dutch TTF gas prices, brent crude oil prices, and EU-ETS carbon prices. Projections for the latter are conditioned by the ECB's technical assumptions.

Since consumer electricity prices have been fixed since 2014, currently there is no transmission of changes in international energy prices or exchange rates to consumer electricity prices. In case such transmission starts to operate, the Bank assumes that a constant mark-up over the wholesale price will be charged, enough for Malta's electricity distributor to generate an adequate operational profit. At the current juncture, it is very challenging to establish this mark-up with reasonable precision due to ongoing Government's price-mitigation measures that are targeted at keeping electricity prices fixed.

Fuel prices

With regards to fuel prices, both petrol and diesel follow a similar methodology. As a first step, refining margins take into account Brent crude oil prices. A pricing rule is then estimated using pre-tax diesel/petrol prices as a function of Brent crude oil prices and refining margins. The estimated elasticity is below one, which implies a partial pass-through of wholesale prices to consumer prices.

[2] See https://ec.europa.eu/eurostat/documents/3859598/9479325/KS-GQ-17-015-EN-N.pdf/d5e63427-c588-479f-9b19-f4b4d698f2a2

In addition, there is substantial lagging behaviour in the pass-through of wholesale prices to fuel prices in Malta. Typically, authorities set the price for a period of 6-12 months. Projections for consumer prices are hence set equal to the forecasted 12-month average consumer price index predicted by the above pricing rule. This introduces a stepped behaviour in the projected fuel index, which is typical of fuel price changes in Malta in recent years. Prior information about the period in which fuel prices are expected to remain fixed is also considered. Taxes are then added to the forecasted pre-tax price to arrive at the final consumer price.

Gas prices

Gas prices in Malta consist of Liquified Petroleum Gas (LPG) only. These are modelled similarly to fuel prices, except that in this case, the wholesale price is linked only to brent crude oil prices. Hence, a pricing rule is estimated whereby gas prices are projected as a function of a 12-month moving average of oil prices. Similar to fuel prices, the elasticity is lower than 1, and hence there is a partial pass-through. Moreover, lagging behaviour is also introduced by setting retail gas prices equal to the 12-month forecasted average of the above pricing rule. Prior information about the period in which gas prices are expected to remain fixed is also considered.

Projections and revisions to the Bank's August projections

In the Bank's previous projection round, electricity prices were expected to remain fixed until the end of 2024. However, gas and fuel prices were projected to rise from 2023 onwards. In light of recent Government announcements, as well as the extension of fiscal support in the Budget 2023, all energy prices are now set to remain fixed until the end of the projection horizon. This implies some downward revisions in fuel and gas prices for the period 2023 and 2024.

The model above can be utilized to estimate, conditional on a set of technical assumptions regarding international energy prices and exchange rates, the extent of fiscal support needed to maintain such policy. Fiscal support is expected to peak next year and gradually decline in 2024 and 2025 as the international prices of oil and gas are forecast to ease. Nevertheless, our estimates suggest that some fiscal support would have to remain in place during 2025, as wholesale prices will remain above their pre-war levels in the medium to long-term.

BOX 2: INFLATION DEVELOPMENTS IN MALTA COMPARED WITH THE EURO AREA[1]

Inflation rates in Malta and the euro area have historically broadly moved in line with each other, indicating some convergence of the Maltese business cycle with that of our main trading partner. Micallef and Cyrus (2013) show that between 1999 and 2012, Malta has experienced higher inflation than the euro area in all but three years.[2] Inflation differentials occurred during periods characterised by structural reforms in Malta. On the other hand, the differential that has emerged during 2022 reflects different causes.

This box looks at inflation developments in Malta over the January-October 2022 period, delving deeper into the distribution of price changes across sub-indices of the HICP at a more disaggregated level in Malta and the euro area.

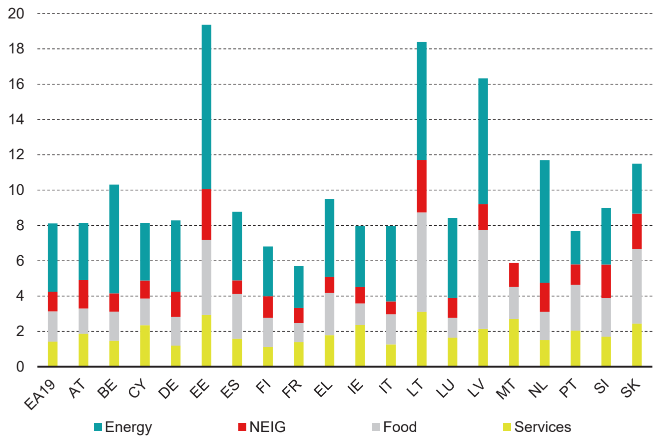
Euro area cross-country inflation heterogeneity

Since the beginning of the year, we note a stark heterogeneity in HICP inflation rates in the euro area, with the highest average rate registered in Estonia and Lithuania, followed closely by Latvia (see Chart 1). Inflation in the Baltic States has been affected by the Russian-Ukraine conflict through their energy dependence on Russia. Furthermore, inflation differentials across the eurozone might reflect different strategies adopted by governments to dampen inflationary pressures on consumers, with some countries opting for more direct intervention in the energy market, while others have relied on transfers to households.

Chart 1 shows that over the January-October 2022 period, Malta registered the second lowest average inflation of 5.9%, which was just slightly above that in France at 5.7%. The main reason behind the relatively low inflation in Malta has been consumer energy prices, which in Malta have been frozen by the Government. Indeed, the contribution of energy inflation to overall inflation in Malta remained nil throughout the period.

By contrast, the annual rate of HICP inflation excluding energy in Malta was higher than the euro area average, and the fifth highest, preceded only by the Baltic countries and Slovakia. This suggests that core

Chart 1
CONTRIBUTION TO HICP INFLATION JAN.-OCT. 2022
(annual percentage point)



Sources: SDW; author's calculations.

[1] Prepared by Abigail Marie Rapa, a senior economist within the Economic Projections and Conjunctural Analysis Office.

[2] See Micallef Brian and Cyrus Laurent (2013) Inflation Differentials in a Monetary Union: the case of Malta, Central Bank of Malta *Working Paper Series*, WP/05/2013.

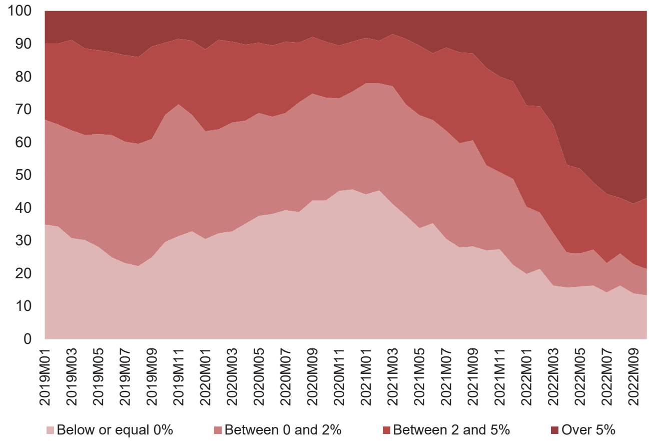
inflation in Malta has been more dynamic than other euro area countries, which could reflect Malta's generally stronger economic activity and other structural factors.

Distribution of inflation rates in Malta and the euro area average

This box also assesses whether the inflation differentials between Malta and other euro area countries is broad-based across HICP items, or if it is driven only by selected components of the consumption basket. Hence, we look at the distribution of price changes across sub-indices of the HICP at a very disaggregated level over time, to understand underlying inflationary pressures. Charts 2 and 3 show a distribution of price changes whereby subcomponents of HICP are categorised into four classes of inflation rates: i) below or equal to 0%; ii) between 0 and 2%; iii) between 2 and 5%; iv) over 5%.

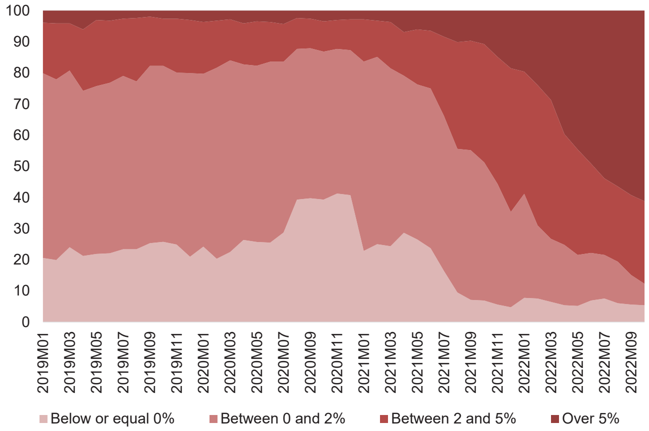
Historically, specifically since 1997, the proportion of the Maltese basket with inflation rates of 0% or negative has been larger than that of the euro area. Indeed, on average 26.8% of Malta's basket items fall in this interval, while this figure stands at 20.2% for the euro area. Furthermore, historically, around 67% of the euro area basket of goods and services falls in the 0-2% and 2-5% intervals in almost equal parts. In both cases, the shares are higher than those in the Maltese basket. On the other hand, while 17.9% of the Maltese basket of goods and services falls in the over 5% interval, only 12.1% of the euro area basket falls in this interval.

Chart 2
PROPORTION OF MT HICP BASKET BY INFLATION PACE
(percentage point)



Source: Author's calculations.

Chart 3
PROPORTION OF EA19 HICP BASKET BY INFLATION PACE
(percentage point)



Source: Author's calculations.

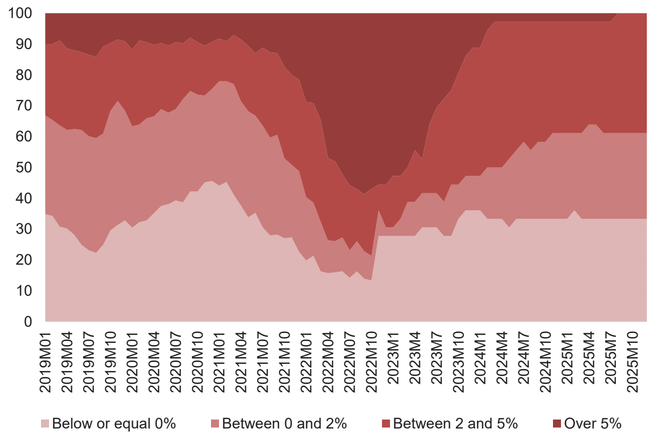
Charts 2 and 3 show that in recent months, the share of subcomponents registering inflation rates in the lowest inflation classes has declined in both Malta and the euro area. As a result, there has been a substantial rise in the share of subcomponents, with year-on-year price increases of more than 5%.

Until August, the share of subcomponents classified as having grown more than 5% was higher for Malta than that in the euro area. However, the share of the basket where inflation was either at 0% or below was also higher than that in the euro area. This suggests that Malta's inflation rate was below that of the euro area in part due to certain subcomponents that are of an administrative nature where prices are controlled by government. Among others, these include energy, post-secondary and tertiary education, passenger transport by bus, medical products as well as tobacco. On the other hand, at least until August, subcomponents that were not administered, increased more sharply than the euro area average.

However, this difference seems to have changed since September. Indeed, the share of subcomponents that have inflation rates above 5% within the euro area basket has exceeded that in Malta. Moreover, for Malta, the share of subcomponents within this interval has declined from 58.8% in September, to 57% in October, while that in the euro area has continued to increase. This could imply that underlying inflationary pressures are bottoming out in Malta, while those in the euro area have continued to increase. This could reflect the fact that the initial impact of rising energy costs in the euro area is now spreading to other goods and services, whereas in Malta the impact is somewhat limited to just imported inflation. Moreover, in Malta, the initial rise in non-energy prices could have been related to the spike in shipping rates, which now appears to be reversing.

Going forward, our projections show a broad-based decline in price pressures with the share of the Maltese basket of consumer goods and services' inflation higher than 5% narrowing strongly (see Chart 4).[3] On the other hand, the interval holding the share of basket of goods and services where price changes are 0% or lower, is expected to increase. This mainly reflects the extension of free public transport announced in the Budget 2023, which has resulted in a negative annual inflation rate of -14.0% in the road transport sub-sector as from October 2022. By the end of the projection horizon, the share of the 2-5% interval is expected to remain slightly above that prevailing in 2019, mainly reflecting some prevalence in wage pressures and imported inflation.

Chart 4
PROPORTION OF MT HICP BASKET BY INFLATION PACE
(percentage point)



Source: Author's calculations.

[3] While past data takes into account around 330 sub-indices, projections include only 36 sub-indices.

Public finance[3]

The general government deficit-to-GDP ratio is set to narrow to 5.6% in 2022, from 7.8% in 2021 (see Table 2). It is projected to narrow further to 5.1% in 2023, 4.0% in 2024 and to 3.0% in 2025. This profile is driven by a declining share of expenditure in GDP.

Table 2
PROJECTIONS FOR MAIN FISCAL ITEMS (% of GDP)

	2021[(1)]	2022	2023	2024	2025
Headline aggregates					
Total Revenue	37.0	36.4	36.9	36.3	36.4
Total Expenditure	44.8	42.0	42.0	40.3	39.4
General Government Balance	-7.8	-5.6	-5.1	-4.0	-3.0
of which: Primary Balance	-6.6	-4.5	-3.7	-2.6	-1.6
General Government Debt	56.3	56.9	58.7	59.9	59.9
Detailed Breakdown					
Current Revenue	35.4	34.7	35.0	35.0	35.1
Current taxes on income and wealth	13.8	13.5	13.6	13.6	13.6
Taxes on production and imports	10.8	11.0	11.4	11.6	11.7
Social contributions	6.2	6.0	5.9	5.9	5.9
Other current revenue[(2)]	4.6	4.2	4.1	4.0	4.0
Current Expenditure	39.6	37.2	37.2	36.2	35.6
Compensation of employees	12.0	11.3	11.3	11.3	11.4
Social benefits	9.5	9.1	9.3	9.3	9.2
Intermediate consumption	8.9	8.5	8.4	8.3	8.3
Interest payments	1.1	1.0	1.3	1.4	1.4
Subsidies	4.7	4.1	4.0	3.2	2.7
Other current expenditure[(3)]	3.4	3.2	2.8	2.8	2.7
Gross Savings	-4.2	-2.5	-2.2	-1.2	-0.5
Capital Revenue	1.7	1.7	1.9	1.3	1.3
Capital taxes	0.2	0.2	0.2	0.2	0.2
Other capital revenue[(4)]	1.5	1.5	1.7	1.1	1.1
Capital Expenditure	5.2	4.8	4.8	4.0	3.9
Gross fixed capital formation	3.9	3.8	3.9	3.2	3.1
Capital transfers	1.2	1.0	0.9	0.8	0.8
Other capital expenditure[(5)]	0.1	0.0	0.0	0.0	0.0
Capital Revenue net of Capital Expenditure	-3.6	-3.1	-2.9	-2.7	-2.5
Underlying budgetary outcome					
Cyclical Component	-0.1	0.2	0.2	0.1	0.0
Temporary Government Measures	-0.4	0.0	0.0	0.0	0.0
Structural Balance	-7.3	-5.8	-5.2	-4.0	-3.0

Sources: NSO; Central Bank of Malta.

[(1)] Actual data as per NSO *News Releases* 188/2022 (published on 21 October 2022) and 154/2022 (published on 29 August 2022)

[(2)] Mainly includes revenue from dividends, rents and sales.

[(3)] Mainly includes spending on education and contributions to the EU budget.

[(4)] Mainly includes grants from EU Programmes.

[(5)] Mainly reflects the value of changes in inventories and in the net acquisition of valuables and other assets.

[3] Ratios in GDP are based on the NSO's *News Release* for the second quarter of 2022, published on 29 August. The GDP release for the third quarter of 2022, published on 29 November, includes ad hoc revisions to past data. As a result, the nominal GDP level has been revised upwards. If this information is taken on board, the deficit and debt-to-GDP ratios presented in this publication would be revised down by around 0.1 percentage point and 1.0 percentage point, respectively.

The deficit ratio is projected to widen when compared with the Bank's earlier projections. This is driven by an upward revision in the profile of expenditure, mainly due to higher outlays on price-mitigating support measures.

In 2022, the share of current revenue in GDP is expected to be lower than that of 2021. It is then expected to increase slightly over the projection horizon. This is mainly due to the profile of tax revenue. In 2022, following a sharp rebound in the previous year, inflows are set to grow by less than nominal GDP. Thereafter, tax revenue is then set to be mainly driven by the profile of indirect taxes – particularly VAT receipts – which are set to grow at a stronger pace than nominal GDP. Other current revenue is expected to grow at, or slightly less than nominal GDP.

The share of capital revenue in GDP is set to peak in 2023 before declining and stabilising in 2024 and 2025, respectively. This is due to the expected profile of EU grants, which part-finance capital expenditure.

The share of current expenditure in GDP is expected to gradually decline over the forecast horizon, mainly due to the profile of subsidies. This reflects the end of COVID-related support measures in 2022, which offsets a sharp rise in subsidies related to price mitigation support. Compensation of employees and intermediate consumption are set to grow by less than GDP respectively, due to a base effect from higher payments on allowances in the previous year and lower COVID-related outlays.

Subsidies related to price-mitigating support measures are set to remain at high levels in 2022, but not to the same levels as COVID-related measures. Price-mitigation support is then set to decline from 2023 onwards, although it is expected to remain in place throughout the forecast horizon.

Spending on social benefits is set to increase by more than nominal GDP in 2023, reflecting the introduction of Budget 2023 measures (see Box 3). It is then set to retain a relatively stable share in GDP. Compensation of employees and intermediate consumption are also set to grow broadly in line with GDP from 2023 onwards.

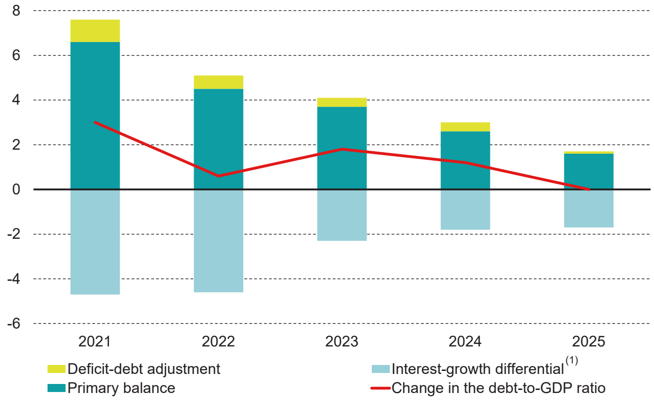
Meanwhile, although still expected to fall in 2022, the share of interest payments in GDP is set to increase from 2023 onwards.

The share of capital expenditure in GDP is projected to remain elevated in the initial years of the forecast horizon, after which it is set to decline, reaching 3.9% of GDP by 2025. This profile reflects a declining share of domestically funded projects and the completion of projects financed from the 2014-2020 EU financing framework. This is partly offset by the projected pick-up in spending on projects financed from grants from the Recovery and Resilience Fund.

The structural deficit is projected to narrow over the projection horizon, reaching 3.0% of GDP by 2025, from 5.8% in 2022. This is due to the unwinding of support measures, as these are not treated as one-off outlays, and thus affect the underlying structural position.

The general government debt ratio is set to increase to just under 60% by the end of the forecast horizon. This is driven by the expected primary deficits, which are partly offset by the interest-growth differential (see Chart 4).

Chart 4
CONTRIBUTION TO CHANGE IN THE DEBT RATIO
(percentage point contributions; percentage of GDP)



Source: Central Bank of Malta.
(1) Difference between effective interest rate (interest payments at year t relative to debt outstanding at year t-1) and GDP growth.

Risks

On balance, risks to economic activity are slightly to the downside in 2023 and more balanced thereafter. The main downside risks relate to the possibility of stronger than envisaged weakness in the international economic environment, which could lead to lower exports. Moreover, renewed pressure on commodity prices and higher imported inflation could adversely impact private consumption and corporate investment. Foreign demand may also be weaker than expected, especially if monetary policy in advanced economies continues to tighten more forcibly than assumed in this projection round. Some of these risks, notably that of higher imported inflation, could be mitigated by additional fiscal support measures. A stronger increase in wages in the context of a very tight labour market, and thus continued labour hoarding, could also offer additional support to household consumption.

Risks to inflation are on the upside during the entire projection horizon. Indeed, further disruptions to Russian oil and gas supplies could increase commodity prices further, and would put additional upward pressure on the prices of imported goods and transport costs. Finally, inflation persistence could be higher than assumed in the baseline, and effects from wages to prices might be stronger than anticipated.

On the fiscal side, risks are on the downside (deficit-increasing) throughout the projection horizon. These mainly reflect the risk of higher-than-expected outlays on price mitigation measures and the likelihood of State Aid to the national airline.

BOX 3: THE IMPACT OF BUDGET 2023 TARGETS ON THE BANK'S FISCAL PROJECTIONS[1]

This box assesses the impact of Government fiscal targets as announced in the Budget 2023, and the Draft Budgetary Plan 2023, on the Bank's latest projections.

Budget 2023 measures

With this Budget, the Government is seeking to support economic growth and protect households and firms from the surge in commodity prices. Vulnerable and low-income persons also benefit from additional social measures. The Budget also promotes supply-side reforms and facilitates the green economy and digital transition.

Newly announced measures mainly reflect an extension of the welfare system. This includes a rise in pensions and benefits for low-income beneficiaries, more generous allowances to carers and parents with children, as well as extended in-work benefits. A new benefit for first-time buyers of property has been introduced. Government also launched a new mechanism, separate from COLA, which will determine a new benefit to low-income households during periods with inflation above 2%. Meanwhile, certain government employees and workers under a public contract will be offered a one-time increase in wages, in order to retain relativity in grades agreed in collective agreements.

Existing measures supporting first time property buyers and purchases of vacant property or buildings in village cores will be renewed. A tax exemption scheme on pension income, first introduced in 2022, will be extended. Tax refunds and other measures to address past anomalies will also be continued in 2023. Meanwhile, Government intends to continue supporting electricity, fuel, and gas distributors in order to retain fixed retail utility prices.

The budget reaffirms the Government's commitment to reduce carbon emissions and the transition towards the green economy. The Speech references the introduction of free public transport and highlights ongoing projects such as the shore-to-ship electricity infrastructure, new waste treatment facilities and building renovations. Many of these projects form part of the milestones listed in the Recovery and Resilience Plan, by means of which Government is eligible for grants from the EU's Recovery and Resilience Fund.

The Budget Speech also mentions ongoing efforts to restructure Air Malta. Talks with the European Commission on the possibility of state aid are ongoing.

As shown in Table 1, in marginal terms, the main budget measures are set to have a deficit-reducing impact in 2023. This is mostly due to the end of support measures introduced in the wake of the COVID-19 pandemic. The Wage Supplement Scheme ended in May 2022. A temporary reduction on stamp and capital gains duty on property purchases, which applies to promise of sale agreements entered into by end-2021, will remain in force until June 2023. Meanwhile, outlays on treatment and vaccinations are

[1] This box was prepared by John Farrugia, Manager within the Fiscal Affairs and Reports Office.

Table 1
IMPACT OF MAIN BUDGET MEASURES
(% of GDP)

	2022	2023
Revenue	**0.21**	**1.53**
No Income tax on pension income, lower income tax on overtime and part-time employment	-0.10	0.01
Schemes for property buyers	-0.11	0.05
COVID measures – reduction in stamp duty and capital gains tax on property sales/purchases	0.73	0.88
COVID measures – lower excise tax on fuel and reimbursement of commmercial and tourism licences	0.10	0.06
Inflation support measures– minimum excise duty applicable on petroleum products	-0.14	0.34
Revenue from Individual Investor Programme and citizenship by investment	-0.45	0.21
Revised interest rates on unsettled tax balances	0.17	-0.01
Expenditure	**0.23**	**0.33**
Increase in pensions	0.17	0.28
Higher social benefits	0.14	0.07
Additional outlays on tax rebates to employees and schemes to address past anomalies	0.03	0.03
COVID measures – support to employers and households and liquidity measures	-2.20	-0.81
COVID measures – health treatment, repatriation and safe reopening of schools	-0.33	-0.18
COVID measures – social measures	0.00	0.00
Inflation support measures – commodity price support measures	1.82	1.03
Inflation support measures – economic stimulus cheques; COLA adjustments for vulnerable persons, Government employees and workers under government contract	0.29	-0.16
Support to national airline	0.31	0.06
Impact on balance	**-0.02**	**1.20**

Sources: Budget Speech 2023; Draft Budget Plan 2023.

set to decline substantially in 2023. The end of these measures is set to boost government revenue by 0.9% of GDP and reduce expenditure by 1.0% of GDP in 2023.

This effect is set to be partly offset by the above-mentioned introduction of new social measures and support measures to retain fixed utility prices. In 2023, their marginal impact is expected to reach 1.3% of GDP.

Revised Government targets

The 2023 Draft Budget Plan (DBP) envisages a continued decline in the deficit-to-GDP ratio. In 2022, this is set to decrease to 5.8%, from 7.8% in the previous year (see Table 2). It is then expected to decline to 5.5% in 2023 and to fall below 3.0% by 2025. Meanwhile, the debt ratio is set to increase from 56.3% of GDP in 2021 to around 60.0% of GDP by 2024 and 2025.

Compared with the targets set in last April’s Stability Programme (SP) Update, a higher deficit ratio is now forecast throughout the projection horizon. This is mainly due to an upward revision of outlays on subsidies. This category captures most of ongoing price-mitigating

Table 2
GOVERNMENT REVENUE AND EXPENDITURE TARGETS
(% of GDP)

	Budget /Draft Budget Plan 2023					Stability Programme Update 2022				
	2021	2022	2023	2024	2025	2021	2022	2023	2024	2025
General government balance	**-7.8**	**-5.8**	**-5.5**	**-4.2**	**-2.8**	**-8.0**	**-5.4**	**-4.6**	**-2.8**	**-2.4**
Revenue	**37.0**	**36.9**	**36.9**	**35.4**	**35.3**	**37.5**	**38.1**	**38.1**	**37.6**	**36.9**
Tax revenue	31.0	31.7	31.2	30.8	30.7	31.4	32.7	32.6	32.7	32.5
Other revenue	6.1	5.2	5.7	4.6	4.6	6.1	5.4	5.5	4.8	4.4
Expenditure	**44.8**	**42.7**	**42.5**	**39.7**	**38.1**	**45.5**	**43.6**	**42.7**	**40.3**	**39.3**
Compensation of employees	12.0	11.4	11.1	10.9	10.8	12.2	12.1	12.1	12.2	12.2
Intermediate consumption	8.9	8.6	8.0	7.6	7.5	9.4	9.9	9.3	9.0	8.8
Social payments	9.5	9.1	9.2	9.0	8.9	9.6	9.8	9.6	9.6	9.4
Interest payments	1.1	1.0	1.3	1.6	1.6	1.5	1.1	1.1	1.1	1.1
Subsidies	4.7	4.7	4.9	4.0	3.2	4.7	2.9	2.9	1.6	1.4
Gross fixed capital formation	3.9	4.0	3.9	3.0	2.9	4.2	4.1	4.2	3.7	3.4
Capital transfers	1.2	1.1	1.1	0.7	0.7	1.1	1.1	1.2	1.0	0.9
Other expenditure	3.5	2.8	3.0	2.9	2.5	2.8	2.6	2.3	2.1	2.1
General government debt	**56.3**	**57.0**	**59.1**	**60.3**	**60.0**	**57.0**	**58.6**	**59.4**	**58.6**	**57.2**

Sources: Budget Speech 2023; Draft Budget Plan 2023; Stability Progamme Update 2022.

support measures. In addition, for 2023, a relatively more conservative profile for tax revenue is expected.

Compared with the SP targets, outlays on intermediate consumption and compensation of employees are set to reach a lower share in GDP. The targeted share of capital expenditure in GDP, particularly in the outer years of the forecast horizon, has also been revised down.

Owing to the higher deficits, the 2023 DBP envisages the debt-to-GDP ratio to be higher than the SP targets. The debt ratio will also peak a year later (in 2024 rather than 2023).

Impact on Bank's fiscal forecasts

Chart 1 decomposes the revisions in the Bank's deficit projection, compared with the August exercise. The impact of newly announced 2023 Budget and ongoing support measures are shown separately. The chart also shows revisions in the projected impact of underlying expenditure, such as wages, previously enacted measures,

Chart 1
REVISIONS COMPARED WITH THE PREVIOUS CBM FORECAST
(positive values indicate a downward revision to the deficit, and vice versa; % of GDP)

Sources: Authors' estimate.

and the profile of capital expenditure. Revisions to the macro-outlook on the deficit ratio are also shown separately.

The Bank's forecasts do not include the impact of measures which have not yet been adopted (i.e., the proposed state aid to the national airline) or those which are hard to determine (i.e., the impact of increased interest rate charges on outstanding tax balances).

On balance, revisions to past data and changes in the recording of certain support measures contribute to a small improvement in the deficit ratio for 2021.

Overall, revisions to the impact of Budget and support measures are deficit-increasing throughout the forecast horizon. This impact is partly mitigated by a revised assessment of the profile of underlying expenditure (particularly capital spending). Revisions in the macroeconomic and price projections exert a deficit-reducing impact in 2022 and 2023, (mainly though a revised profile of tax revenue) and a small deficit-increasing impact in 2024.